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Ms. Anne Stausboll  
Interim Chief Investment Officer  
California Public Employees' Retirement System  
400 P Street, Suite 3492  
Sacramento, CA 95814

Re: Fiscal Year 2009 Incentive Compensation Proposals

Dear Anne,

You requested Wilshire's opinion regarding the proposed incentive compensation schedules for more than three dozen members of Staff for the fiscal year 2009. As you are aware, Wilshire reviewed all of these plans in depth and forwarded our comments/concerns to you and the HR department over the last few weeks. We subsequently received updated/corrected versions of all of the sheets, which we reviewed a second time. In some cases, we noticed additional/new errors of which I advised you and HR, and then subsequently reviewed a third set of incentive compensation plans.

### **Recommendation**

At this time, we reservedly recommend that the Performance and Compensation Committee approve the 2009 plans in their current form. Last year, we expressed reservations about a number of plans due to concerns about whether the incentives and performance targets were appropriate and satisfied the concerns expressed by members of the Investment Committee. The CIO at that time, Russell Read, assured Wilshire and the Investment Committee that all of these issues would be examined in time for the approval of the 2009 plans. Obviously, Dr. Read's departure has resulted in a delay for the examination of potential changes to these plans. We have re-stated our reservations below, but recommend approval of these plans at the present time and assume that Staff will address these issues during the 2009 Fiscal Year.

We recognize that the Performance and Compensation Committee and the Investment Committee may very well support some of the low minimum performance targets outlined below, but, in light of multiple past comments by a number of Board members about the appropriateness of such targets, at the very least the Performance and Compensation Committee should be offered a chance to formally discuss whether such targets are in CalPERS' best interest.

## **Total Fund Performance**

As I outlined in my letters to the Performance and Compensation Committee dated May 25, 2007 and August 1, 2007, and as is currently included in the incentive compensation worksheets for FY 2009, members of Staff who have a total fund incentive factor still receive substantial rewards if the performance of the PERF is markedly below the passive policy benchmark. We recognize that this is consistent with past practice, and so do not newly object to a continuation of this policy for another year, but encourage you to re-examine this performance metric over the next year to insure that members of CalPERS' Staff are rewarded for actually adding value to the PERF's performance relative to the passive alternative, if that is the desire of the Performance and Compensation Committee.

Currently, for all members of Staff concerned, total fund incentive compensation begins to be paid if performance is 40 basis points under the benchmark and reaches its maximum at 20 basis points over the benchmark. Not only does this implicitly state that the Investment Committee expects underperformance on average, but it provides Staff with no incentive to continue to generate the superior returns seen in recent years, such as the 150+ basis point outperformance in FY 2007.

## **Global Equities**

As with the Total Fund Performance, Global Equities is the one asset class where members of Staff still receive substantial fractions of their incentive compensation if performance is below the benchmark, both at the asset class level and for many of the internally managed portfolios. However, we believe it is fundamentally unfair to require Fixed Income, AIM, and Real Estate to outperform their passive benchmarks uniformly (with the sole exception of the currency hedging portfolio) to receive incentive compensation, but allow Global Equities Staff to receive incentive compensation despite underperformance by up to 50 basis points. Like with the total fund, the range of returns expected for the Global Equity total portfolio is asymmetrical, with maximum incentive compensation paid at 15 basis points of outperformance, indicating that on average, Global Equities is expected to underperform the passive alternative and that Staff will be rewarded for such underperformance.

In fairness to Global Equity Staff, we do recognize that this is the one asset class with substantial index fund allocations, which can underperform the benchmark due to a combination of cash drag, transactions costs, and no opportunity for value-added, and so some allowance for total asset class and portfolio underperformance is probably necessary. However, the order of magnitude of the "acceptable" underperformance in the index funds, as expressed by the ranges from minimum to maximum incentive compensation payouts, far exceeds any reasonable level of underperformance that could be expected from the passive portfolios and should be tightened substantially. Were the index funds to actually underperform consistently their benchmarks by 20 or 30 basis points (a range which allows for the payment of some incentive compensation), I would

expect that both Wilshire and the Investment Committee would press Staff for an explanation of why these funds should not be moved to an external index fund provider.

## **AIM**

Over the last few years, members of the Performance and Compensation Committee have questioned how well the Custom Young Fund Benchmark actually matches the investments in the AIM portfolio, given the drastic outperformance by AIM relative to that benchmark in some recent years. While we have no objection to the Young Fund Index in general, which has long been CalPERS' AIM benchmark, Wilshire has worked closely with Staff to develop a new incentive compensation performance calculation which better reflects the nature of the private equity industry. We believe that this new structure addresses the Investment Committee's recurring questions regarding whether AIM performance is being properly measured.

Given the wide spread in performance between the median and best private equity investors, which can be an order of magnitude greater than that found in the public markets, it is difficult to determine what value-added target is appropriate.

CalPERS' long-stated goal for the AIM program has been to be "the investor of choice", with access to the best opportunities and partners in the industry.

In our opinion, the new performance metric captures the essence of that goal by requiring the AIM program to consistently outperform the majority of its peers to achieve any incentive compensation, and to rank in the top 30 percent or better of all its peers to receive the maximum incentive compensation award.

Regardless of market / industry performance or the performance spread between the median and best investors, this new methodology will require the AIM Staff to consistently rank among the top private equity investors in the industry, helping to achieve the Investment Committee's performance goals for this program.

## **Fixed Income, Real Estate, Inflation-Linked Assets, and Asset Allocation / Risk Management**

Wilshire also reviewed the incentive compensation plans for the remaining members of Investment Staff, and we believe that all comments and input we provided have been properly included in these plans.

In our letters to the Performance and Compensation Committee last year, Wilshire questioned whether the core-oriented NCREIF Index is the best benchmark for the CalPERS Non-Core Real Estate portfolio, and we were assured that this matter would be addressed as part of Dr. Read's comprehensive review of the incentive compensation

system. Again, in light of the suspension of that restructuring, we urge you to address this benchmark issue in time for the FY 2010 plan review.

We note that the REIT benchmark has been changed in the Incentive Compensation plans to reflect the new benchmark per the most recent annual strategic plan, and agree that this benchmark should be used in these plan calculations.

### **Overall Plan Factor Calculations**

We have previously discussed with you the following element of the incentive compensation calculations which you intend to examine over the next year, and I believe that the Performance and Compensation Committee should provide us with direction regarding whether the following is an issue that should remain the same or be changed:

For individuals with multiple quantitative factors (the majority of people), each factor is calculated independently and has no bearing on the calculations for other factors. In other words, if an employee performed just well enough on one part of their incentive compensation to warrant a 1.50x but had absolutely horrific performance on another, the poor score would not dilute the bonus potential from the first element. If a total asset class underperformed by 5 percent, for example, but an individual portfolio added a small amount of value, a PM, SPM, or SIO would still earn a fractional bonus based on the well-performing portfolio, even though the entire asset class generated a loss for CalPERS. Although I do not necessarily agree that this system needs to be changed, as it does reward people for doing well despite a tough environment, in light of the questions that have been raised over the last few years by members of the Performance and Compensation Committee about this methodology, I believe that this warrants some formal discussion and guidance.

### **Conclusion**

I will be present at the June and August Performance and Compensation Committee meetings to address any of the specific plans or the contents of this letter in person, but, of course, if you have any additional questions, please do not hesitate to contact me in the interim.

Sincerely,

